Classification: Public

A response to the HMT's Call for Evidence

Aligning the ring-fencing and resolution regimes

November 2023

1. Introduction

1.1. UK Finance is the collective voice for the banking and finance industry. Representing over 300 firms, we act to enhance competitiveness, support customers, and facilitate innovation.

1.2. We welcome this opportunity to respond to HM Treasury's (HMT)'s *A smarter ring-fencing regime: a consultation on near-term reforms* (the Consultation).

1.3. The consultation forms part of the Chancellor's Edinburgh Reforms, launched in December 2022, which are designed to drive growth and competitiveness in the financial services sector. We are pleased the Government is delivering on its commitment to overhaul the ring-fencing regime, through the launch of this consultation. As with other measures in the Edinburgh reforms, we urge the Government to see through its reforms and deliver real change at pace.

1.4. Whilst the scale and importance of the industry to the UK economy necessitates a strong, effective and independent regulatory regime, we also need regulation that is proportionate and supports both competition and innovation, thereby helping the sector to grow safely and with confidence.

1.5. Our members, who are impacted by the ring-fencing regime, have contributed to this response. This includes the ring-fenced banking groups (RFBs), UK subsidiaries of non-UK firms with growing retail franchises in the UK and our associate member, Allen & Overy. As there was no standard 'blueprint' for ring-fencing and each financial institution implemented ring fencing in the most appropriate manner for their business model, and some of our contributors are not subject currently subject to ring-fencing, views on the near-term reforms and their impact vary between members.

1.6. The significant majority of our members believe that the ring-fencing rules should be removed and are disappointed that HMT has not taken up the spirit of the Panel's recommendations. The UK financial system has so far proved resilient in recent real-life examples of stress, including the Covid-19 pandemic, Russia's invasion of Ukraine, and market turmoil relating to Silicon Valley Bank (SVB) and Credit Suisse and major banks have been deemed resolvable by the Bank of England (BoE). To this end, our members look forward to engaging with HMT on the long-term future of ring-fencing as it publishes its policy proposals next year.

1.7. A small minority of members consider that the ring-fencing regime is already working well as implemented and do not believe that significant parts of the near-term reform proposals are needed.

1.8. The rest of this response reflects the views of the significant majority of members, unless indicated otherwise, and sets out high-level observations and recommendations in response to HMT's questions in the Consultation.

1.9. Our members will be responding bilaterally to the questions posed in the Consultation.

2. Summary of key points from the consultation response

2.1. We support HMT's intention to improve the functionality of the ring-fencing regime in the near-term by relaxing certain aspects and remedying some unintended consequences of the regime. Our members consider the near-term reforms an important first step in the evolution of the ring-fencing regime and support the implementation of a more flexible and adaptable regime. Our members appreciate HMT's intention to implement the near-term reforms swiftly.

2.2. Overall, the significant majority of our members welcome the package of near-term reforms. They consider that the ring-fencing regime can be significantly improved, to enhance the international competitiveness of UK firms and limit the ongoing compliance burden of the regime, without introducing additional systemic risk. However, there are some questions from members on:

(a) whether the near-term reforms (which in part seek to address some unintended consequences of the existing regime) themselves create some unintended consequences,

(b) whether the proposed amendments to the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 (the **EAPO**) and / or the Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014 (the **RFBCAO** and together with the EAPO, the Secondary Legislation) achieve HMT's stated aims, or

(c) whether additional or further reforms might be appropriate.

2.3. Where members anticipate that the near-term reforms will give rise to potential unintended consequences, we have highlighted this below. Where members consider that HMT's stated aims would be better achieved through an alternative approach to amendments to the EAPO and / or RFBCAO, we have sought to set out clearly what such alternative approaches would entail. Should HMT require further detail on any alternative approach suggested in this response, we would be happy to engage at HMT's convenience.

2.4. Among the unintended consequences identified:

(a) The expansion in the geographic scope of "core deposits" would bring certain banks into the ring-fencing regime for the first time and impose considerable unnecessary costs on ring-fenced banking groups with respect to non-EEA (European Economic Area) depositors. Non-ring-fenced banks (NRFBs) in groups subject to ring-fencing may be forced to transfer non-UK/non-EEA deposits which become "core deposits" for the first time when these reforms coming into effect. This would not only cause disruption to the depositors concerned but also impair the funding and liquidity positions of those NRFBs, with associated safety and soundness risks, and create a considerable risk to confidence in UK banks and financial stability as these NRFBs seek to replace funding simultaneously.

(b) The proposed secondary threshold would create asymmetry between RFBs and banks that are excluded from the regime as a result of the secondary threshold, leading to competitive distortions. In this light, the significant majority of members consider that RFBs should also be permitted to engage in de minimis trading activities, which would not create any additional financial stability risks. It would, however, create wider benefits to the UK economy by allowing ring-fenced banks to benefit from the same proportionality benefit as those banks excluded by the secondary threshold, and thereby also better serve customers.

(c) The proposal to permit RFBs to incur exposures to Relevant Financial Institutions (RFIs) which qualify as small and medium sized enterprises (SMEs) is limited to investment firms; we consider that RFBs should be permitted to incur exposures to all SMEs.

(d) The proposed definition of SME is too complex to be workable in practice; we have proposed an alternative definition, in line with that applied by the Basel committee, which is simpler and more straightforward to implement.

(e) The proposal to allow FX collars does not achieve the aim of facilitating SMEs' risk management strategies; we think that products beyond collars would be necessary to achieve this.

These issues are expanded on in our responses below.

2.5. As regards potential additional or further reforms, we believe that HMT should engage with concerns regarding the complexity of the definition of "relevant financial institution" set out in article 2 of the EAPO. One of the key findings of the Ring-fencing and Proprietary Trading (RFPT) Review Panel was that *"[t]he definition of, and prohibitions related to, Relevant Financial Institutions (RFI) are overly complex and burdensome resulting in unintended consequences and undesirable outcomes for banks and their customers*." Members had also welcomed the RFPT's recommendation that the definition be moved into the Prudential Regulation Authority (PRA) Rulebook, to facilitate greater flexibility in its application (although this is not considered a complete resolution to the related concerns regarding the complexity of the definition) and were disappointed that HMT has not sought to implement that recommendation. Operationalising the RFI definition in account-opening and monitoring procedures is a major ongoing cost of ring-fencing: the definition needs to be rationalised and simplified.

2.6. Furthermore, as we indicated in our response to the RFPT review, we recommend that certain provisions in the ring-fencing legislation would more appropriately sit in PRA regulation - specific priorities in this regard are addressed throughout our response. This could be achieved within a framework of parliamentary oversight but would permit the various thresholds and a risk-based approach to be adopted. It would also enable adjustments to the regime where statute-determined operational inefficiencies arguably stand in the way of good customer outcomes. This would also facilitate the evolution of the regime with experience and evidence and changes could be made to the regime to make it operationally more effective for firms, their customers and the UK economy. We consider that this change would improve the competitiveness of the UK's banks and improve customer outcomes. Despite the benefit that changes of this nature would bring, we stress that consideration of these changes should not delay implementation of the current near-term reforms under consideration by HMT.

2.7. We urge HMT to carefully consider their approach to implementing the near-term recommendations to improve the operational efficiency of the ring-fence and to ensure they are simple to execute. If it is too complicated or introduces additional implementation burden, the effect of the reforms will be less beneficial or in extremis not applied.

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CONSULTATION RESPONSE

3. Deposit threshold

Question 1 – Do you agree with the proposal to increase the ring-fencing deposit threshold to £35 billion of core deposits?

3.1. Our members do not have a collective view on the proposal to increase the ring-fencing deposit threshold to £35 billion of core deposits given the different business models.

4. Secondary threshold

Question 2 –
(i) Do you agree that the proposed numerator for the secondary threshold – trading assets excluding those acquired under article 6(2) EAPO – is an appropriate proxy for banks' dealing as principal and commodities trading activity as defined by the ring-fencing regime?
(ii) Do you agree that using trading assets would be a more practical way of measuring the secondary threshold, rather than relying on the definition of excluded activities set out in legislation?
(iii) Are there any alternative metrics that you think would be better for the purposes of the secondary threshold? If so, explain what they are and what greater benefits they would offer.

4.1. Overall, the significant majority of our members welcome the proposal of a secondary threshold. Whilst we consider the use of trading assets is not a perfect proxy for banks' dealing as principal and commodities trading activity, it is a relatively easy approach to implement and therefore members are supportive.

4.2. The significant majority of our members however query the consistency of imposing a secondary threshold which permits retail focused banks that meet the primary threshold to remain outside of the ring-fencing regime and therefore conduct excluded activities (albeit only to a limited extent) without also allowing RFBs to undertake excluded activities to a similar degree. If the policy view is that trading activities (or, more broadly, excluded activities) which in aggregate do not exceed 10% (or 25% as we suggest below) of a bank's capital cannot pose undue risk to the bank's core activities, that must remain the case regardless of whether the bank in question is ring-fenced or not. Members therefore consider that for firms that would remain RFBs an aligned secondary threshold and de minimis amount (as further discussed in section 5 below) would be more consistent.

Question 3 – Do you agree with the proposed calibration – at 10% of tier 1 capital – for the secondary threshold?

4.3. The significant majority of our members consider that the proposed calibration of the secondary threshold at 10% of tier 1 capital is inconsistent with other areas of regulation. Banks are subject to requirements relating to large exposures which prevent banks from having an exposure to a single counterparty or group of connected counterparties that is higher than 25% of its tier 1 capital. In keeping with the large exposures limit, we would propose that the secondary threshold should be calibrated at 25% of tier 1 capital. Since trading assets would be diversified, rather than a single entity or connected counterparties, they would present less risk than any single large exposure that an RFB can otherwise take on in the existing regulatory framework.

Question 4 – Do you agree with the proposal that banks that are part of G-SIBs should not be exempt from the ring-fencing regime as a result of the secondary threshold?

Question 5 –

(i) Do you agree with the proposed approach to calculating tier 1 capital and trading assets on a consolidated basis under the requirements in UK CRR, and where UK CRR does not apply to a particular UK sub-group, to approach the calculations as if the financial institutions in the sub-group and the sub-group itself were subject to UK CRR?
(ii) Are there any other alternative approaches to consolidation that you would consider more appropriate – for instance, in the case of a UK sub-group not subject to UK CRR, to apply consolidation requirements in accordance with the applicable regulatory framework?

4.4. Our members do not have a collective view on questions 4 and 5 of the consultation given the different business models.

5. De minimis threshold

Question 6 –
(i) Do you agree with the proposal to allow RFBs to incur exposures of up to £100,000 to a single RFI at any one time?
(ii) Do you agree that this proposal would alleviate the compliance burden of the ring-fencing regime on firms?

5.1. Our members welcome the proposal to relax the ring-fencing regime in relation to exposures to RFIs, although note that the exposure threshold of £100,000 to a single RFI is an extremely low threshold. A more meaningful impact would be achieved by a package of measures that includes the de minimis threshold as proposed, a further aspect to the de minimis threshold aligned to the secondary threshold and the exclusion of SMEs from the RFI definition: see further our responses to questions 7 and 14 below.

5.2. Our members consider that the proposed exception, set out in draft Article 19C of the EAPO, would alleviate part of the compliance burden of the ring-fencing regime on firms, in that it would effectively limit the circumstances in which breach reporting is required. However, this approach does not alleviate the need for an RFB to ensure that all clients have been assessed for RFI status as they are onboarded and as their status may change – given the complexity of the RFI definition, this burden is significant. Further, members are concerned that the additional burden and associated system changes required to implement the proposed de minimis threshold, i.e., to operationalise the monitoring of RFI exposures nearing the £100,000 threshold, would not be outweighed by the associated reduction in breach reporting obligations.

5.3. Members consider that an alternative approach, whereby an entity is excluded from the definition of "relevant financial institution" until such time as the RFBs exposures to it reached a set threshold would better achieve HMT's desired policy outcomes, whilst also achieving a more meaningful reduction in the compliance burden on firms. This is because the need to assess whether an entity is an RFI would not arise until such time as a meaningful exposure had been incurred.

Question 7 – Do you agree that the Panel's de minimis threshold recommendation would not be easy to implement in practice? If you do not, please explain your rationale and any alternative options along with their benefits.

5.4. Members consider that for certain firms the benefit of such a threshold would outweigh the practical difficulties in implementing and, as such, consider that the greater flexibility afforded by the Panel's de minimis threshold recommendation would be welcome.

5.5. Further, as set out in paragraph 4.2 above, members consider that HMT's proposed approach to permit retail focused banks that meet the primary or secondary threshold to remain outside of the ring-fencing regime and therefore conduct excluded activities (albeit only to a limited extent) without also allowing RFBs to undertake excluded activities to a similar degree lacks consistency.

5.6. Noting that RFI exposures may not be fully captured within "trading activities" (for example, because an RFI exposure may take the form of a loan), and that "trading activities" may not be entirely comprised of RFI exposures, we suggest that the de minimis exception should therefore have two parts:

(a) an exception for any RFI exposure which is below a de minimis threshold, as discussed in paragraph 5.1 above; and

(b) an exception for "trading activities" which would otherwise be "excluded activities", which in aggregate do not exceed 25% of tier 1 capital.

Our members do not consider that it would be difficult to implement a de minimis threshold of this nature as a proxy for excluded activities and prohibitions.

6. Geographical restrictions

Question 8 – Do you agree with the proposal to allow RFBs to establish operations outside of the UK or EEA?

6.1. A significant majority of our members support the proposal to allow RFBs to establish operations outside of the UK or the EEA, which is achieved via the deletion of Article 20 of the EAPO. Some of our members have previously encountered scenarios where potential mergers and acquisition targets have had operations outside of the UK/EEA, meaning that target entities could not be held inside the ring-fence. This proposal would help with the ability to hold acquired entities inside of the ring-fence on Day 1.

6.2. However, the proposed change to the prohibitions under the EAPO is accompanied by a change to the geographical scope of the core deposits threshold under Article 2 of the RFBCAO, such that deposits held in branches outside the UK and EEA will be counted as core deposits (unless eligible for exemptions) for the first time. Our members consider that what constitutes a core deposit for the purposes of the threshold is unrelated to the third country activity permitted to be undertaken by an RFB.

6.3. The extension of the core deposit definition would have a number of consequences for UK banking groups whose UK non-ring-fenced banks have non-UK/EEA branches, including significant upheaval for groups' structures and funding models with associated financial stability risks.

6.4. All UK banks would need to identify existing depositors with non-UK/EEA branches; assess and quantify which of these are core deposits (or would be but for an exemption under the RFBCAO for qualifying organisations, qualifying group members, or eligible individuals). All affected banking groups would face higher compliance costs, be it the ability to identify these deposits on an ongoing basis or, more considerable costs of establishing ring-fencing if they are not currently subject to the regime or having their funding model disrupted if they are.

6.5. To the extent a bank is not subject to ring-fencing, it would need to assess whether the additional core deposits would put it over the £35 billion threshold and may as a result be ring-fenced. This would considerably disrupt regulatory certainty and predictability of the UK as a financial centre.

6.6. To the extent the organisation is already subject to ringfencing requirements, it would immediately be in breach of these requirements, and would therefore need to transfer deposits to the RFB. Any such transfers are likely to cause confusion and upheaval for non-UK depositors and considerably disrupt the funding models and liquidity positions for the affected NRFBs. This could directly impact their safety and soundness and create additional financial stability risks in financial markets as NRFBs simultaneously have to replace the lost funding.

6.7. There seems to be no meaningful UK financial stability gain, but substantial downsides and risks, in the inclusion of deposits held in non-UK or EEA branches in the calculation of the core deposits

thresholds. We would recommend that the geographical scope of the definition rather be reduced to UK deposits only, as the inclusion of the EEA within scope is a legacy of membership of the EU and serves no real purpose in delivering financial stability benefits.

6.8. More broadly, the EAPO and RFBCAO should be reviewed in detail to ascertain whether it is appropriate to retain references to the EEA in other places.

6.9. We note that the PRA is consulting in parallel on how it would manage risk arising from third country branches and subsidiaries of ring-fenced bodies. While these rules are in the PRA's gift, our members would like further information on the interaction between the PRA's assessment of third country supervision and the wider UK equivalence regime run by HMT.

7. Mergers & Acquisitions (M&A)

Question 9 – Do you agree with the proposal to introduce a four-year transition period for complying with the ring-fencing regime where ring-fenced banking groups acquire another bank that is not subject to ring-fencing?

7.1. Our members welcome the proposal to introduce a four-year transition period for complying with the ring-fencing regime where RFB groups acquire another bank that is not subject to ring-fencing.

7.2. In line with this policy, it would be helpful if HMT could provide some confirmation that the ring-fencing regime should also allow for the acquisition of other non-bank businesses, for example wealth management businesses, by providing a similar four-year transitional period. The acquisition of non-bank business is not restricted by the provisions of the RFBCAO, but rather by the PRA's expectations that an RFB will not hold any interest in a "excluded activity entity" as per paragraph 2.3 of the PRA's Supervisory Statement Ring-fenced Bodies (SS 8/16). SS 8/16 could usefully be updated to confirm that the PRA will also allow a four-year transitional period for RFBs to bring acquired business which are not banks into compliance with the ring-fencing regime.

8. Equity investments

Question 10 – Do you agree with the proposal to permit RFBs to:
(i) make direct minority equity investments in UK SMEs,
(ii) make investments in funds that invest predominantly in UK SMEs and
(iii) acquire equity warrants in UK SME borrowers, up to 10% of tier 1 capital?

8.1. Our members support the proposal to permit RFBs to deal as principal in investments to make direct minority equity investments in UK SMEs, make investments in funds that invest predominantly in UK SMEs and acquire equity warrants in UK SME borrowers, as set out in the draft article 7A of the EAPO.

8.2. The significant majority of our members consider that a permitted allowance of investments up to 10% of tier 1 capital is not consistent with existing rules, and that a limit in line with the current large exposures limit (i.e., 25% of tier 1 capital) would reflect a wider policy position on risk and would reduce operational difficulties in implementation.

8.3. The permitted investment limit is proposed to be calculated on the carrying value of the investments (per draft Article 7A(2)(b)), and so a bank could breach the limit if the investments increase in value. As drafted, there is no headroom for a bank to then dispose of its investments if the limit is breached due to an increase in the value of investments. We would encourage HMT to include headroom, and a period of time, for banks to dispose of investments if they breach the limit. An approach to drafting for this within HMT's proposed Article 7A of the EAPO might be as follows:

(2) Paragraph (1) does not apply unless:

(a) the sum of the value of relevant investments held at any time by the ring-fenced body is less than ~~10~~ 25 per cent of the value of the tier 1 capital held by the ring-fenced body on an individual basis or a sub-consolidated basis (within the meaning of Article 4(1)(49) of the prudential requirements regulation), as applicable; or~~, and~~

(b) where the sum of the value of relevant investments held at any time by the ring-fenced body exceeds 25 per cent of the value of the tier 1 capital held by the ring-fenced body on an individual basis or a sub-consolidated basis (within the meaning of Article 4(1)(49) of the prudential requirements regulation), it has done so a continuous period of 12 months or more.

(2A) ~~f~~For the~~se~~ purposes~~—~~ of sub-paragraph (2):

(a) "relevant investments" means shares, equity warrants or other investments acquired or made by the ring-fenced body in reliance on paragraph (1);

(b) the value of relevant investments is their fair value, assessed in accordance with International Financial Reporting Standard 13 (fair value measurement) issued by the International Accounting Standards Board in May 2011, as amended from time to time;

(c) tier 1 capital has the meaning given in Article 25 of the prudential requirements regulation, and the value of the tier 1 capital held by the ring-fenced body is to be calculated in accordance with the prudential requirements regulation.

8.4. As regards the equivalent exception to the prohibition on financial institution exposures, our members have noted that drafted Article 14(7)(b) incorrectly refers to "financial instrument exposure" rather than "financial institution exposure".

Question 11 – To what extent do you think this proposal would help to unlock equity financing in the UK and address UK SMEs' financing needs? If responding as a ring-fenced group, would you undertake this type of activity?

8.5. We would refer HMT to our members' bilateral responses to the Consultation. We note, however, that any benefit achieved by the proposal will be curtailed by the proposed implementation of Basel 3.1 standards by the PRA.

Question 12 – Is the UK CRR definition of SME viable as a size limit for equity investments, both directly and indirectly through funds? If you believe it is not, please suggest an alternative definition. The government is open to considering alternative definitions that may better reflect current market practices and investment strategies, provided that this supports the overall policy objective.

8.6. Our members do not consider that the UK CRR definition of SME is appropriate as a size limit for equity investments, given the complexity of that definition. The more complex the definition, the less likely it is that the SME definition will align with the definition used by banks and funds, and therefore may act as a barrier to investment. This complex definition is based on an EU definition that has recently been amended (article 1 (2)(b)(8)) to simplify the definition of an SME in line with the Basel definition.

8.7. Instead, in line with our response to the PRA's Consultation Paper CP 16/22, we would recommend alignment with the Basel definition (CRE 20.47), which references €50 million of turnover, based on the accounting definition of Group Consolidated Turnover. This would also make the SME definition consistent with other parts of the PRA's Rulebook, such as the firm size adjustment under the IRB approach. Given the UK has left the EU, it would also seem appropriate to make the thresholds more coherent and denominated in GBP rather than historic EUR conversions. As such, and for simplicity, we propose a turnover threshold of £50m. Our suggested drafting follows:

7A(8)(b) a "UK SME" is an undertaking which—

(i) at the time of the transaction referred to in paragraph (1), is an SME, where SME refers to any entity which is part of a consolidated group having turnover

which is less than or equal to £50million in its most recent accounting year ~~*within the meaning of Article 4(1)(128D) of the prudential requirements regulation*~~*, and (ii) is registered in, and has its principal place of business in, the United Kingdom.*

8.8. HMT (and PRA) could also consider a broader reconsideration of the SME definition used in financial services laws and regulation, aligned with the Government's proposed corporate reporting secondary legislation for large enterprises, so that medium sized enterprises within SMEs could be up to a turnover of £750m, the threshold for large enterprises. Any such broader reconsideration should not delay implementation of the near-term reforms now proposed by HMT.

Question 13 – On the proposal to permit investments in funds that invest predominantly in UK SMEs:
(i) what do you perceive as the risks and benefits of this proposal?
(ii) if responding as a ring-fenced group, can you provide further information on the type of funds you may consider investing in?
(iii) would you consider establishing a fund that meets the conditions set out in the draft secondary legislation?
(iv) do you consider that the proposed types of permitted funds capture those which are currently operating in UK SME markets?

8.9. We note that, in response to sub questions (ii) and (iv), the current drafting of Article 7A means it is unclear whether our members will be able to invest in the funds currently operating in UK SME markets, for example the Business Growth Fund PLC (BGF). Our members note that an "SME investment fund" must be structured as an AIF under draft Article 7A(3)(a), although draft Article 7(A)(4) permits the acquisition of shares issued by an SME investment fund structured as a corporate body. We would welcome clarity on whether investment in BGF or similarly structured funds is permitted.

8.10. Furthermore, we note that other aspects of the current drafting may make existing funds ineligible for RFB investment. Funds which invest in UK SMEs may also have significant assets (for example, loans to underlying companies or cash or treasury assets) which are not equity investments into UK SMEs, meaning that they do not meet the 70% SME investment threshold for eligibility to be held in an RFB. In addition, the proposed SME definition may also limit the extent to which the proposed types of permitted funds capture those currently operating in UK SME markets.

9. Exposures to small financial institutions

Question 14 – Do you agree with the proposal to permit RFBs to have exposures to RFIs that qualify as SMEs?

9.1. Our members welcome the proposal to permit an RFB to have exposures to RFIs that qualify as SMEs. However, contrary to the stated policy intention, HMT's proposed drafting amendment to article 2(3) of the EAPO only allows for SMEs which are investment firms and does not extend to other types of RFIs. This approach does not (i) fully meet the objective of ensuring that SMEs have access to financing and financial services, and creates an anomalous distinction between investments firms and other types of RFI that may undertake similar or overlapping activities (for example, UCITS (Undertakings for Collective Investments in Transferable Securities) managers or AIFMs (Alternative Investment Funds Managers) and investment holding companies may be SMEs), or (ii) alleviate any of the significant compliance burden on firms in connection with the need to assess clients and counterparties for RFI status, against the very complex definition of RFI. An approach which excluded all SMEs from the definition of an RFI would allow an RFB to first assess for SME status and, if that was met, would avoid the need for an RFB to assess a prospective client against the more complicated limbs of the current RFI definition, although policy considerations may differ across different types of RFI.

9.2. Further, our members consider that the proposed definition of "SME" is both complex to operationalise and is not the most appropriate definition in this context. As further discussed in paragraph 0 above, for simplicity, we propose aligning the definition with the PRA prudential rules.

9.3. Our suggested drafting, reflecting the concerns of the significant majority of our members, as expressed in paragraphs 9.1 and 9.2 above follows:

> *(f) investment firms which~~:~~*
>
> > *~~(i)~~ are not authorised to carry on by way of business (in the United Kingdom or the EEA) the activities specified by either article 14 (dealing in investments as principal) or article 21 (dealing in investments as agent) of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001; ~~or~~*
>
> *(fa) entities which* are SMEs, *where SME refers to any entity which is part of a consolidated group having turnover which is less than or equal to £50million in its most recent accounting year* ~~*within the meaning of Article 4(1)(128D) of the prudential requirements regulation*~~*;*

9.4. As per paragraph 8.8 above, HMT (and PRA) could also consider a broader reconsideration of the 'medium' in SME definition by reference to that used for defining large enterprises in the government's corporate reporting regulation proposals.

10. Trade finance

Question 15 – Do you agree with the proposal to clarify that RFBs can have exposures to RFIs where those are incurred to support standard trade finance activities?

Question 16 – Do you consider that there are any standard trade finance activities which should be permitted, but would not be permitted under the new exemption? If so, please explain why.

10.1. Our members agree with the policy intention to allow RFBs to undertake a broader range of trade finance activities, given the benefit of such activities to the wider UK economy. However, we have concerns that the proposed amendments to Article 15 of the EAPO do not align with, or fully achieve, HMT's stated policy intention.

10.2. The Consultation states at paragraph 3.80 that the government wishes to clarify that RFBs should be able to enter into "*SBLCs, bills of exchange and promissory notes, and arrangements which take place under a master agreement such as debt factoring*". The proposed drafting in Article 15 does not cover these arrangements.

10.3. Moreover, our members are concerned that the proposed amendments to Article 15 of the EAPO would have unintended consequences, in that the requirement for the supplier or recipient of the goods and services to which the transaction relates to a customer of the RFB, as per draft Article 15(1)(c) of the EAPO, excludes the possibility that the RFB's customer may be an intermediary in the supply chain. This restriction would narrow the scope of trade finance activity that an RFB could undertake. Our members would prefer for no changes to be made rather than for the current changes and their unintended consequences to be introduced.

10.4. To the extent that HMT is minded to retain the proposed Article 15(1)(c) in some form, is "customer" as referenced in draft Article 15(1)(c) intended to refer to a relationship arising in connection with the relevant transaction, or whether the relationship might arise pursuant to a separate unconnected product (e.g. a corporate transaction banking account)? The drafting does not provide for any limitation in this regard, and we consider that there are good policy reasons to allow for the "customer" relationship to arise in unconnected contexts – for example, the customer may request that the RFB enter into an arrangement with a third party, where that arrangement ultimately supports the customer's business. It would be helpful if HMT could provide appropriate clarification.

11. Debt restructuring

Question 17 – Do you agree with the proposal to broaden the scope of the exemption that permits RFBs to engage in "debt for equity swaps"?

11.1. We welcome the proposal to broaden the scope of the exemption that permits RFBs to engage in "debt for equity swaps", as the current exemptions relating to debt restructuring are overly narrow. However, we do not consider that the current drafting achieves HMT's stated aims.

11.2. We consider that the requirement for a "relevant release of debt" is overly restrictive. Debt restructuring will commonly involve accommodations being made to borrowers which are not releases of existing debt; for example, repayment terms may be altered, covenants may be waived or new funds might be extended, or where warrants or options are used, to allow the bank to share in possible upsides. Were the debt for equity swap exception to be amended to permit a wider range of restructuring options, we consider that this would maximise the likelihood of an RFB being able to deploy tools that might successfully alleviate the financial difficulties faced by the debtor, leading to better outcomes for customers and mitigating the potential risks of business failures on the wider UK economy. Given the costs to business of giving up equity, or rights to equity, and to banks in holding shares in prudential capital terms, we also consider that the risk of such tools being aggressively used by RFBs remains low.

11.3. Further, Article 15 of the EAPO as proposed to be amended by HMT does not allow an RFB to:

(a) acquire equity or other instruments issued by a new entity established as part of the restructuring which may not, at the time of issue, be a member of the original debtor's group. A situation whereby a new company ('Newco') is formed by the lenders to facilitate a debt for equity swap issues of shares to the participating lenders before the debt is novated to Newco and the subsequent debt for equity swap takes place, is fairly typical. There may also be tax structuring or other reasons as to why a Newco may come into the original debtor's group at a later stage;

(b) provide funding to an independent third party which acquires the borrower or the business and assets of the borrower in an open and competitive sales process and which issues equity to the RFB in connection with the transaction;

(c) participate in rights issues or issuances of new equity, after it has taken an initial equity position as a result of a debt for equity swap – this may result in dilution of the RFB's position; or

(d) receive other incentives in the form of instruments linked to the proceeds of sale of certain of the borrower's business, fees linked to equity value or instruments linked to other relevant returns. Depending on how they are drafted, such instruments could look like a derivative. The analysis of whether such an instrument is, or is not, a derivative is complicated and cumbersome but, as these would be 'upside only' instruments, they would not give rise to any exposure for the RFB which would hamper the policy aims of the ring-fencing regime.

The complexities inherent in these issues mean that they can lead to RFBs being unable to commit to restructuring plans in a timely fashion, thereby increasing the risk that a financial rescue package may not be agreed or may not be successful.

11.4. It would also be helpful to clarify the interplay between Article 15 and the PRA's restriction on an RFB having a participating interest in an "excluded activity entity". Where a debt for equity swap would result in an RFB having a participating interest in a debtor, the PRA restriction would prohibit this (if the debtor was an "excluded activity entity"). As we have suggested in response to question 9 (paragraph 6.2) above, some form of accommodation from the PRA in this regard – for example

a transition period enabling the RFB to dispose of the equity or restructure the business of the former debtor - would be helpful.

Question 18 – Do you consider it necessary for there to be a requirement for a release of debt as well as a financial difficulties safeguard?

11.5. No, members do not consider that a "release of debt" should be a necessary pre-condition. Se further our response to question 17 above.

Question 19 – Do you consider that a more specific test than "financial difficulties" would be helpful?

11.6. Our members are comfortable with the proposed "financial difficulties" test.

Question 20 – Are there any circumstances in which shares or other instruments would be issued as part of a debt restructuring, where no release of debt takes place (e.g., where shares are issued in consideration for other amendments to the loan terms)?

11.7. Yes – see our response to question 17 above.

Question 21 – Are there any transaction structures which have been provided for in the new exemption, which you consider unlikely to arise in practice (e.g., where warrants or options are issued which are exercisable on a release of debt)?

11.8. No – the transaction structures within the scope of the current draft amendments to Article 15 of the EAPO are all realistic possibilities.

Question 22 – Are there are any other standard ways of structuring a debt for equity swap which are not captured in this proposal? If so, please explain what they are and provide evidence as to why they should be captured by the exemption.

11.9. Yes – see our response to question 17 above.

11.10. Members' preference would be to broaden the scope of the exception to allow the RFB to hold shares or instruments giving entitlement to shares provided that the transaction ultimately results in lenders having effectively "swapped" debt for equity in a business and that lenders have adhered to the spirit of what is intended.

12. Servicing central banks

Question 23 – Do you agree with the proposal to permit NRFBs to service central banks outside of the UK?

12.1. Our members agree with the proposal to permit NRFBs to service central banks outside of the UK.

Question 24 – Are there any other multilateral and/or multinational organisations that should be included? If so, please provide further detail.

12.2. Our members consider that it would be helpful and appropriate to expand the scope of other multilateral and/or multinational organisations that an NRFB can service. For example, Part 1 of the Schedule to the Financial Services and Markets Act 2000 (FSMA 2000) (Exemption) Order 2001 (the Exemption Order) sets out a number of organisations that are exempt from any regulated activities other than insurance business. Whilst that list significantly overlaps with the list of persons from whom received funds will not amount to the regulated activity of accepting deposits, as per Article 6 of the FSMA 2000 (Regulated Activities) Order 2001 (RAO), meaning that funds received from such persons cannot be "deposits" and thus cannot be "core deposits" for the purposes of the

RFBCAO, the following entities are named in the Exemption Order but not in Article 6 of the RAO and therefore might usefully be added to Article 2(2) of the RFBCAO:

(a) The Bank for International Settlements;
(b) Bank of England Asset Purchase Facility Fund Limited;
(c) Covid Corporate Financing Facility Limited;
(d) UK Infrastructure Bank Limited; and
(e) EU and European Atomic Energy Community

12.3. Our members also consider that it would be sensible for this list to be set out in PRA Rules, to make amendments easier.

13. Inflation swaps

Question 25 – Do you agree with the proposal to permit RFBs to offer inflation swap derivatives?

13.1. The significant majority of our members agree with the proposal to permit RFBs to offer inflation swap derivatives.

13.2. The definition of "inflation swap" proposed for inclusion as article 10(2)(ba) of the EAPO would only permit an RFB to offer fixed: floating rate inflation swaps derivatives. Members have commented that clients can have legitimate reasons for wishing to execute other forms of inflation swap, for example, floating: floating rate swaps, and would encourage HMT to consider a broader definition and broader approach as wet out in section 19 below.

13.3. Our members note that the wider regulatory framework contains a number of safeguards for retail clients which would apply in the context of these products (for example, the consumer duty, which is relevant to all RFBs). It is acknowledged that certain derivative products are not appropriate for all clients.

14. Mortality risk and lifetime mortgages

Question 26 – Do you agree with the proposal to permit RFBs to hedge mortality risk?

14.1. Our members welcome the proposal to permit RFBs to hedge mortality risk which may arise if a customer was to die sooner than expected. This would, as HMT suggests, ensure that RFBs were able to hedge the risks associated with lifetime mortgage products, for example. However, our members note that, to hedge the risks associated with lifetime mortgage products responsibly, RFBs would also need to be permitted to hedge longevity risk. We would suggest that this is permitted by adding (i) "longevity risk" as a new limb (g) to Article 6(1) and a new limb (f) to Article 14(3) of the EAPO, and (ii) a new defined term, as follows, to Article 1(4) of the EAPO:

"longevity risk" means the risk that a person to whom an undertaking has loaned money lives longer than anticipated by the undertaking at the time when the loan was agreed;

15. Share dealing errors

Question 27 – Do you agree with the proposal to permit RFBs to deal as principal for the purpose of correcting the failure of a securities trade which is due to error?

15.1. Our members agree in principle that the proposal to permit RFBs to deal as principal for the purpose of correcting the failure of a securities trade which is due to error is helpful.

15.2. Share dealing errors may also arise in circumstances where the trade does not fail. Depending on the nature of the error, it may be that a firm would be required to deal as principal to correct it. Our

members consider that RFBs ought to be permitted to deal as principal where required to correct errors in conducted trades, as well as in the context of failed trades.

15.3. Further, the proposed drafting of Article 6(8) of the EAPO would permit an RFB to deal in investments as principal in order to prevent a failure, but not to remedy a failure if it was discovered after the event. This appears to be misaligned with HMT's policy intention. In addition, we consider that an RFB ought to be able to deal as principal where necessary to remedy an erroneous trade which has been successfully executed. We would suggest the following drafting amendments to address this:

> *(8) A ring-fenced body does not carry on an excluded activity by dealing in investments as principal to:*
>
> > *(i) prevent or remedy the failure of a transaction which it would have or has entered into as agent for a customer where the failure would have been or is due to a systems or operating error, or*
> >
> > *(ii) remedy an erroneous trade,*
>
> *provided that the investment concerned can be allocated to the customer and is so allocated as soon as practicable after the transaction.*

Question 28 – Do you agree with the proposal that a security should be allocated as soon as practicable following acquisition?

15.4. Our members do not have a particular view on question 28.

16. Test trades

Question 29 – Do you agree with the proposal to permit RFBs to deal in investments as principal for the purpose of undertaking test trades?

16.1. We support the proposal to permit RFBs to deal in investments as principal for the purpose of undertaking test trades.

Question 30 – Are counterparties during test trades sometimes RFIs? If so, would a new RFI exemption need to be introduced for the purposes of conducting test trades? Or would the proposed £100,000 RFI exposure de minimis be sufficient?

16.2. Counterparties during test trades are sometimes RFIs. HMT's proposed exception for test trades is drafted as an exception to the "excluded activities", such as dealing as principal in investments, but not as an exception to the prohibition on financial institution exposures. Our members consider that an additional exception, to be included in Article 14 of the EAPO, would be helpful. This approach would seem more appropriate than an attempt to exclude counterparties to test trades from the scope of the RFI definition as it would apply only in the specific context of test trades and not more generally to any exposure to the RFI counterparty concerned.

17. Divestments

Question 31 – Do you agree with the proposal to permit RFBs to deal in investments as principal when they are divesting debentures in the circumstances outlined above?

17.1. We welcome the proposal to permit RFBs to deal in investments as principal when they are divesting debentures where the loan, credit or guarantee and the debenture are being sold together.

18. Trustee services

Question 32– Do you agree with the proposal to clarify that RFBs may incur exposures to RFIs where they act as trustees for minors or CIOs?

18.1. We agree with the proposal to clarify that RFBs may incur exposures to RFIs where they act as trustees for minors or charitable incorporated organisations.

18.2. In our response to the RFPT, we requested that both Articles 6(7) and 19(7) of the EAPO should be amended to expressly refer to nominees in Scotland, following the form of words used in Article 66(1) of the RAO. This is to reflect the legal form of such arrangements under Scots law. Our suggested (further) amendments to Articles 6(7) and 19(7) are:

(7) A ring-fenced body may incur a financial institution exposure that arises where the ring- fenced body is acting as trustee or, in Scotland, as nominee for or on behalf of any individual, minor, charity or CIO.

Question 33 – Do you consider that further provision needs to be made for nominees in the exemptions that allow RFBs to deal in investments as principal and incur RFI exposures when acting as trustee?

18.3. We consider that further provision does need to be made for nominees in the exemptions that allow RFBs to deal in investments as principal and incur RFI exposures when acting as trustee.

19. Derivatives

Question 34 – Do you agree with the proposal to clarify that RFBs may offer certain collar products? Do you agree that the proposed legislative change will achieve this?

19.1. The significant majority of members welcome the proposal to clarify that RFBs may offer certain collar products, which are important tools to help customers manage their risk.

19.2. Collar products are generally options; as such, our members have questioned whether the provision to allow for collar products would better sit in Article 11 of the EAPO, which deals with permitted options and swaptions, rather than in Article 10 of the EAPO. For the sake of flexibility, it may be better to reflect the proposal in both Article 10 and Article 11 of the EAPO.

19.3. Our proposed drafting follows:

Proposed Article 11(4):

(4) The requirements listed in this paragraph relate to foreign exchange collar transactions and are that—

(a) the transaction consists of a cap or floor (or both) relating to two specified currencies under which —

(i) if, on a relevant exercise date, the prevailing rate of exchange (“the spot FX rate”) between the two specified currencies is above the cap rate, the customer and the ring-fenced body will exchange the specified currencies at the cap rate,

(ii) if, on a relevant exercise date, the spot FX rate between the two specified currencies is below the floor rate, the customer and the ring-fenced body will exchange the specified currencies at the floor rate, and

(iii) if, on a relevant exercise date, the spot FX rate between the two specified currencies is neither above the cap rate nor below the floor rate, the customer and the ring-fenced body will not exchange the specified currencies.

(b) the agreement relating to the cap and/or the floor specifies—

(i) the two specified currencies to which the cap and/or the floor relate;

(ii) the applicable cap rate and/or the applicable floor rate;

(iii) the relevant exercise date; and

(iv) the identity of the party (which will be either the customer or the ring-fenced body) that is purchasing the cap and/or the identity of the party (which will be either the customer or the ring-fenced body) that is purchasing the floor."

Explanatory Note for Article 11

Article 11 permits a ring-fenced body to sell certain options to its account holders, including *interest rate caps and floors, and* interest rate swaptions, and foreign exchange collars. *Article 11(4) relates to foreign exchange collar transactions. It describes the transactions as a combination of a cap transaction and a floor transaction relating to two specified currencies. Some market participants may refer to such cap and floor transactions in their documentation as a put option and a call option, and they may refer to the two specified currencies as a put currency and a call currency. They may also refer to the applicable cap rate and the applicable floor rate as being strike prices, whilst the relevant exercise date may be referred to as an option expiration date and the party purchasing the cap or the floor may be referred to as an option buyer.*

19.4. The rationale for describing the foreign exchange collar transactions using cap and floor terminology is to maintain consistency with the cap and floor concepts already used in Article 11(2). We have provided some guidance in our suggested amendments to the Explanatory Note for Article 11 above as to how the cap and floor terminology used in Article 11(4) links to the put, call and strike price concepts that will be familiar to many market participants in the context of FX collar transactions.

19.5. Our members would also recommend including a new provision permitting transactions that give the customer or the RFB a right to buy/sell currency, as this would help clients manage their risk. (this also relates to Question 49). This could be achieved by inserting the following into the EAPO.

Proposed Article 11(5):

(5) The requirements listed in this paragraph are that—

(a) The transaction between the customer and the ring-fenced body ("the original transaction") gives the customer or the ring-fenced body a right to buy or sell foreign currency with one of more of the following additional features:

1. the customer has an obligation to buy or sell the foreign currency under the original transaction at a specified exchange rate if the spot FX rate for the specified currencies is above or below a pre-agreed rate on a specified date,

2. the original transaction terminates early with neither the customer nor the ring-fenced body being required to make a payment to the other party if the spot FX rate for the specified currencies is above or below a pre-agreed rate,

3. the exchange rate applicable in respect of the original transaction may be adjusted depending on whether the spot FX rate for the specified currencies is above or below a pre-agreed rate on a specified date,

4. the ring-fenced body has the right to enter into an additional transaction with the customer on the same terms as the original transaction if the spot FX rate for the specified currencies is above or below a pre-agreed rate on a specified date, or

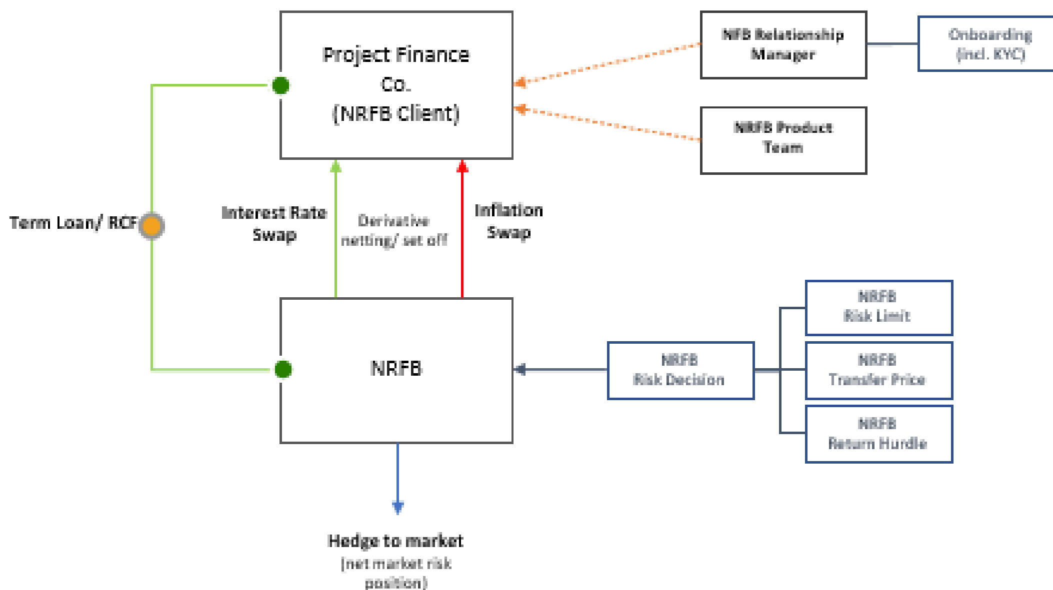
5. the notional amount applicable in respect of the original transaction may be adjusted depending on whether the spot FX rate for the specified currencies is above or below a pre-agreed rate on a specified date.

19.6. More generally, the significant majority of our members also think that a holistic approach to derivatives to enable RFBs to support and meet their clients' needs should be introduced. Clients need access to a full product suite to enable a portfolio approach to hedging, and the ability to reflect changing needs over time (for example due to fluctuating supply chains, acquisitions, high growth, or larger contract tendering). Clients also need the ability to hedge with one bank, given the significant administrative burden which arises from facing two separate banking relationships (for example, KYC (Know Your Customer), AML (Anti Money Laundering), financial control and credit processes).

19.7. We provide below some illustrative examples of client transactions and the current complexities, as provided in our response to the RFPT review panel in 2021.

Project finance and customer derivatives

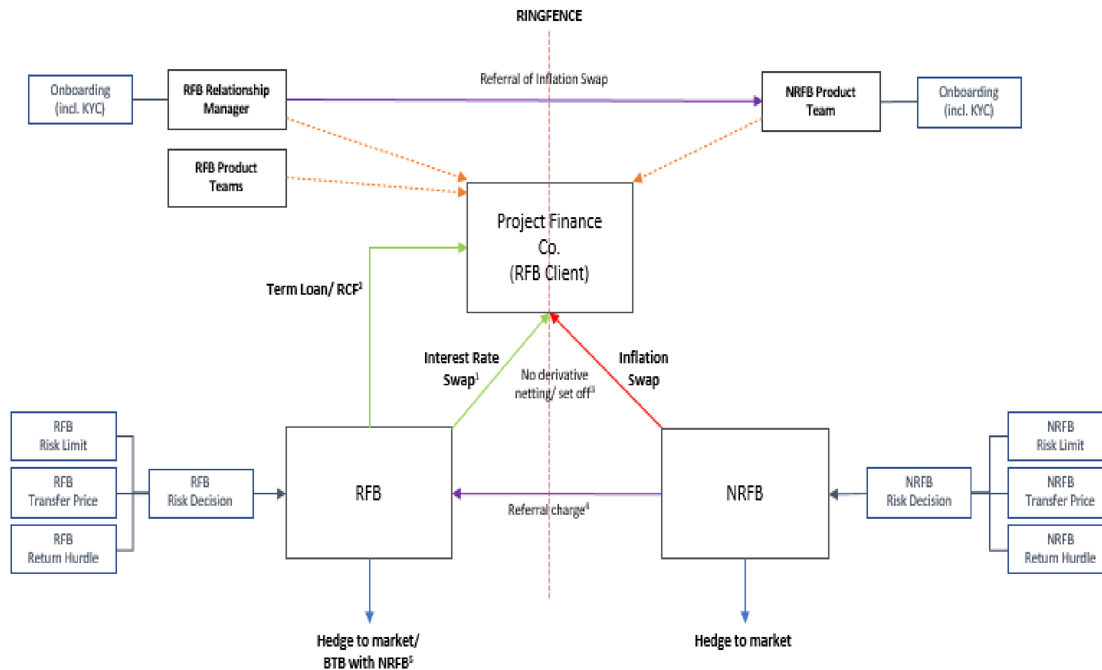
A commonly used simplified project finance transaction provides a real-world example of the relative complexity created for an RFB in serving a corporate client on a transaction involving a mixture of permitted and prohibited business. This is illustrative of the complexity and friction that arises as a result of the ring-fencing regime when an element of the transaction is prohibited business, which ultimately impacts an RFB's ability to serve its clients and efficiently apply its UK deposits to fund productive investments for the benefit of the UK economy (such as UK infrastructure projects).The diagrams below outline the relative simplicity of serving a corporate client on the same transaction through a NRFB. It demonstrates an advantage of locating corporate banking business outside the ring-fence, although that precludes the use of retail deposits to fund UK infrastructure projects (such as wind/ solar).



FX derivatives

Similar issues to those described in the "Project finance and customer derivatives" case study above also impact an RFB's ability to service its clients' FX requirements. By way of example, a client of the RFB operates internationally, with its operating currency being sterling and with a number of its material customer and supplier contracts priced in euro and US dollars. The RFB has developed a strong relationship with the client providing products to manage their FX risk and developing their FX strategy using the type of vanilla FX derivatives that are permitted under the ring-fencing regime.

The diagram below outline the relative complexity created for an RFB in serving a corporate client on a transaction involving a mix of permitted and prohibited business. It is a scenario that plays out in project finance and FX in particular, with the dynamics affecting the client journey and the return allocation between the RFB and NRFB.



1 The ability of the RFB to enter into the interest rate swap depends on headroom below the limits specified in article 12 of the EAPO. If the client is an RFI (e.g. a structured finance vehicle), then the RFB cannot enter into the interest rate swap, even if the client qualifies as an infrastructure special purpose vehicle under article 19 of the EAPO.
2 The RFB cannot rely on article 19 of the EAPO to provide a credit facility to the borrower if it is an RFI as an 'asset holding company' because the definition of infrastructure special purpose vehicle is limited to an entity whose only business is financing qualifying infrastructure (as opposed to building and operating it). This would preclude the provision by the RFB of liquidity facilities at the Opco level in a financing structure that includes a bond issue secured (directly or indirectly) on the project assets.
3 Derivative netting/ set off is preclude because (a) the derivatives are in two different entities and (b) rule 14 of the PRA ring-fencing rules prohibits it.
4 The referral should be on arms length terms pursuant to rule 12 of the PRA ring-fencing rules. The referral charge must also be taken into account for the purposes of rule 13 of the PRA ring-fencing rules.
5 If the interest rate swap is hedged back to back with the NRFB, initial margin must be posted by each party and variation margin exchanged as the intra-group margin exemption under EMIR is not available.

Here, the client has expressed an interest in using structured FX products, and to have the ability to execute any other type of FX product, where such products are determined to offer a better commercial solution as compared to vanilla FX derivatives. To satisfy the client's requirements and be able to offer them the full range of FX products, the client would need to be referred to and onboarded with an NRFB. This results in the material drawbacks and adverse outcomes relating to a referrals solution, including duplication of administrative, legal and regulatory steps required for onboarding and the client's products being split across two separate entities (i.e., the RFB and NRFB) resulting in ongoing additional administrative burden for the client, for example regarding settlements.

Further, this additional complexity results in increased costs in servicing the client's requirement for additional FX products. This may mean that providing such additional products is not commercially viable for the NRFB leading to the client engaging other providers to service their FX requirements who are not subject to the ring-fencing regime and consequently are able to offer the client the full range of FX products through a single entity. Accordingly, a practical result of the ring-fencing regime is that an RFB is unable to effectively compete with other providers in servicing their clients' FX needs.

19.8. We would also encourage the removal of restrictions on tenors of Options products, the removal of the conditions relating to derivatives in subsections (a), (b) and (c) in Article 12(1) EAPO and increasing the overall limit on derivatives.

19.9. Our members note that the wider regulatory framework contains a number of safeguards for retail clients which would apply in the context of these products (for example, the consumer duty, which is relevant to all RFBs). It is acknowledged that certain derivative products are not appropriate for all clients.

19.10. As indicated in paragraph 2.6, the boundaries would be better facilitated and monitored if the derivative framework was encompassed within PRA rulebook rather than legislation.

20. Structured finance vehicles

Question 35 – Do you agree with the proposal to provide that an SFV qualifies as a sponsored SFV of an RFB where its assets were created or acquired by that RFB or by another RFB in the same group?

20.1. We agree with the proposal to provide that an SFV qualifies as a sponsored SFV of an RFB where its assets were created or acquired by that RFB or by another in the same group.

21. Correspondent banking definition

Question 36 – Do you agree with the proposal to clarify that RFBs are permitted to incur exposures to RFIs where the exposure arises from correspondent banking arrangements, which involve more than two credit institutions?

21.1. We support the proposal to clarify that RFBs are permitted to incur exposures to RFIs where the exposure arises from correspondent banking arrangements which involve more than two credit institutions.

21.2. However, our members consider that further clarifications are needed to ensure that the scope of permitted "correspondent banking" fully aligns well with established market practices. In particular:

(a) the entities involved in a correspondent banking arrangement may not be "credit institutions" (i.e., deposit taking banks), but could include payment services firms;

(b) services are not always provided directly to the client; and

(c) services do not always constitute payment services for EAPO purposes.

21.3. As such, we consider that the definition of "correspondent banking" appearing in Article 1(4) of the EAPO could usefully be amended as follows:

> *"correspondent banking" means an arrangement between two or more payment services providers ~~credit institutions~~ pursuant to which one payment service provider ~~credit institution~~ provides payment services to another payment service provider or to clients of one or more other payment service providers ~~credit institutions~~ on behalf of that those payment service providers ~~credit institution~~;*

with related amendments to be made to the definition of "payment services" as follows:

> *"payment services" means any of the activities specified in Part 1 of Schedule 1 (payment services) ~~has the same meaning as in regulation 2(1)~~ of the Payment Services Regulations 2017 or equivalent services, howsoever defined, when carried out outside of the UK;*

22. Grace period for NRFBs

Question 37 – Do you agree with the proposal to introduce a twelve-month grace period for NRFBs to move customers to RFBs that are no longer classified as an RFI?

22.1. We welcome the proposal to introduce a twelve-month grace period for NRFBs to move customers to RFBs that are no longer classified as an RFI.

23. Notice of determination for onboarding

Question 38 – Do you consider that the NoD requirement should be removed for onboarding NRFB customers, and if so, why?

23.1. Our members agree with the views of the RFPT panel that the NoD requirement unreasonably lengthens the onboarding process and impairs the client experience when compared to non-UK banks that do not have to issue NoDs. We would support the removal of the NoD requirement. Further details in support of this position will be provided in members bilateral responses.

24. Status of trustees and insolvency practitioners

Question 39 – Do you agree with the description of the issue relating to the status of trustees and insolvency practitioners?

Question 40 – Please provide an assessment of how significant an issue this is for you. Do you face issues providing or accessing banking services on either side of the ring-fence?

24.1. Our members have no comment.

25. Conduit vehicles

Question 41 – Do you agree with the description of the issue relating to the definition of "conduit vehicles"?

25.1. In the view of our members, the description of the issue(s) relating to the definition of "conduit vehicles", as set out in the consultation, does not fully capture all of the industry's concerns. See further our response to question 42 (paragraphs 25.1 et seq.) below.

Question 42 – Is there any further evidence or reason for why this definition should be amended? If so, what changes would you propose making?

25.2. UK Finance is grateful for HMT's views in connection with the policy intention behind the scope of the exemptions for so-called "A" vehicles (ACVs).

25.3. In our response to the RFPT review, we had also highlighted that it is unclear why so-called "D" vehicles (as defined in Article 17(2)) (DCVs) have been referred to in Articles 6(1), 7(1), and 17(2) but not Article 7(2). Article 7(2) permits an RFB to acquire any instrument creating or acknowledging indebtedness from one or more of its sponsored SFVs. In the absence of an exemption from Article 7(2) for an RFB acquiring a relevant instrument from a DCV (as defined in Article 17(2)) and as contemplated by Article 17(2)(b)), the excluded activity may operate to restrict certain otherwise permitted connections/exposures to relevant conduit vehicles/D vehicles, which are common in securitisation structures.

25.4. Article 7(3) goes on to permit sales of such instruments, and of other assets acquired from a sponsored SFV, provided that certain conditions as to the underlying assets are met. Unhelpfully, Article 7(2) and 7(3) do not refer to acquisitions from, or on-sales of notes acquired from, conduit vehicles: this concern has been flagged with HM Treasury as there would not appear to be any policy reason for conduit vehicles not being referenced.

25.5. Against this background, we would suggest that Article 7 of the EAPO could usefully be amended as follows, without any departure from existing policy:

> *7(1) A ring-fenced body does not carry on an excluded activity by selling investments to or buying investments from a sponsored structured finance vehicle of the ring-fenced body, or from a conduit vehicle of the ring-fenced body.*

(2) A ring-fenced body does not carry on an excluded activity by acquiring any instrument creating or acknowledging indebtedness issued by one or more of its sponsored structured finance vehicles or one or more conduit vehicles of the ring-fenced body.
(3) Subject to the condition in paragraph (4) being met, a ring-fenced body does not carry on an excluded activity by selling any legal or beneficial interest in—
(a) investments acquired from a sponsored structured finance vehicle of the ring-fenced body or from a conduit vehicle of the ring-fenced body, or
(b) instruments creating or acknowledging indebtedness issued by a sponsored structured finance vehicle of the ring-fenced body or from a conduit vehicle of the ring-fenced body.
(4) The condition referred to in paragraph (3) is that the relevant investments or instruments must relate to assets that fall within the description set out in article 3(2)(gc).

25.6. Further, in the context of warehouse securitisation deals, the structured finance vehicle (which will be securitisation undertaking and hence an RFI) will typically issue notes to fund its acquisition of assets. It is not clear whether such arrangements are within scope of Art 17(1) EAPO because it may not be possible to consider such note issuance as an 'incidental activity' (as referenced in Article 17(1)(a)).

25.7. It would therefore be helpful if Article 17(1) might be amended as follows:
17(1) A ring-fenced body may incur a financial institution exposure to a relevant financial institution ("A") where—
(a) the only business of A (apart from incidental activities) is to acquire, hold and manage assets from or for an undertaking which is not a relevant financial institution ("B") and to enter into arrangement for the purposes of funding acquisitions of such assets; and

(b) all or part of A's assets are being used to form the whole or part of the security for a loan or any other finance provided to A by the ring-fenced body or by a conduit vehicle of the ring-fenced body for the benefit of B.

26. Related undertakings

Question 43 – Do you agree with the description of the issue relating to the definition of "related undertakings"?

Question 44 – Is there any further evidence or reason for why this definition should be amended? If so, what changes would you propose making?

26.1. Our members are in favour of flexibility. The definition of "related undertaking" is limited to subsidiary undertakings of a parent undertaking. It does not therefore extend to entities in which the RFB has a participating interest, for example a 50/50 joint venture entity. RFBs should be able to deal and have exposures for the purpose of mitigating risks arising with respect to entities in which it has a participating interest as well as subsidiary undertakings.

27. Qualifying organisations and groups for NRFBs

Question 45 – Do you agree with the description of the issue relating to the definition of qualifying organisations and groups?

Question 46 – Under what circumstances have you found, if any, that charitable trusts, companies, and associations established by a "qualifying group" cannot be banked by an NRFB?

27.1. Some members highlight that this will still be an issue as they have seen some practical examples of related entities being split across the RFB and NRFB because, for example, the trust entity in question cannot qualify under the income test, and as a result is not a "Qualifying organisation" as defined. As such, the trust may have substantial assets but cannot satisfy the gross income test. In

other situations, the entity in question may not be deemed as a "Qualifying Group Member" either because such entities may not be established as "group" entities within the meaning of s421 of FSMA. One suggestion of tackling this is to enable future financial projections to be taken into account, or expand the test for organisations that are not partnerships or body corporates to also include its assets and not just its gross income.

28. Globally Systemically Important Insurer

Question 47 – Should an alternative definition of large insurers be introduced to replace the current reference to the FSB's G-SII list in the RFI definition?

Question 48 – Is the current reference to G-SII in the RFI definition still appropriate and should it therefore be retained.

28.1. Our members consider that it would be helpful for the definition of G-SII to be accessible in UK law or regulation. Wherever the definition appears, it will be important for the definition to remain relatively static over time. Further, it would be helpful for the definition to be simple and set out a list of specific insurance entities.

29. Structured FX products

Question 49 – Do you consider that RFBs are unduly restricted under the existing legislation from providing structured FX products to their clients? If so, please provide detailed evidence on the relevant types of structured products and corresponding financial instruments, and how they are currently prohibited.

29.1. Our members consider that RFBs are unduly restricted by the existing legislation from providing structured FX products to their clients. Such products are intuitively plausible and common hedging strategies for SMEs, whereby they pay a fee to gain a benefit such as an enhanced strike rate or participation in upside. In particular, it would be helpful for an RFB to be able to offer structures that allow a client to buy one option (or forward) and sell another. Examples of structured FX products that would be helpful for an RFB to be able to offer include:

(a) forward extra / forward extra plus, where the client participates in favourable FX movements up to a point; if that is exceeded the client gets a pre-agreed rate; and

(b) ratio knock out forwards, where the client receives a better rate than the prevailing forward rate but if there is an adverse currency movement beyond a trigger point the hedge ceases to exist.

29.2. In this context, it is important to highlight the relevance of the consumer duty, relevant to all RFBs. It is acknowledged that structured FX products are not appropriate for all clients. However, the client base of an RFB is not limited to consumers or retail clients and flexibility would be welcome. In particular, SMEs may have activities overseas, for which a wider range of FX products would be useful. We provided an SI drafting suggestion in our response to Question 19.

30. Other areas

Question 50 – Are there other areas where you consider technical changes to the ring-fencing legislation regime are needed?

30.1. We have raised certain other areas where we consider further reform would be helpful throughout the body of our response above, where appropriate - see, for example, our comments at paragraph 2.5 regarding the RFI definition.

30.2. In addition, our members consider that Article 6(4)(d) of the EAPO should be amended to refer not only to shares in a company, but to ownership interests in any undertaking (with a similar change in

Article 6(5)). This would clarify that RFBs can acquire capital interests in e.g. LLPs and units in a Collective Investment Scheme (CIS). We consider that this amendment is necessary or otherwise holdings in entities which are investments (due to the broader terminology used in the Regulated Activities Order) but which are not shares in a company may not be permitted. We further consider this change to be facilitative and not a shift in policy intention.

30.3. Our members would like to stress that any consideration of these points by HMT should not delay implementation of those near-term reforms on which HMT has already consulted.

31. Impact assessment

Question 51 – What do you expect the impacts to be of the proposed near-term reforms, in particular on: (i) competition in the banking sector; (ii) the competitiveness of banks; (iii) customers (individuals and businesses); and (iv) the UK's financial stability.

31.1. Our members consider that UK banks are currently at a competitive disadvantage to their global peers, as the ring-fencing regime has resulted in the fragmentation of capital, duplicative coverage models, the inefficient provision of products and higher costs. Ultimately, this has a negative effect on the ability of a UK bank to provide products and services to customers.

31.2. We consider that the near-term reforms will remove some of the adverse impact of ring-fencing on the competitiveness of UK-headquartered banks, and in particular highlight the transitional M&A proposal and the ability for RFBs to build a presence outside of the EEA. However, we note that ring-fencing is particular to the UK's regulatory framework and makes the UK a global outlier, which in itself is a barrier to the ability of UK banks to be competitive.

31.3. Our members consider that the customer experience will be improved by the near-term reforms, although we note that the ring-fencing regime has created difficulty in offering a smooth customer experience, as customers have to be onboarded and serviced by both the RFB and NRFB. Further developments are required to realise the benefits of the current proposals.

31.4. The significant majority of our members believe that the near-term reforms and the related amendments proposed throughout this response will have no adverse impact on financial stability.

Question 52 – Do you expect any of the proposals in this consultation to lead to potential unintended consequences, including any associated costs, if implemented? If so, please provide detail.

31.5. We have addressed a number of potential unintended consequences throughout our responses to specific questions.

Question 53 – For banks subject to ring-fencing, what do you expect the cost and benefits of implementing the proposed near-term reforms to be? Where possible please provide numerical values in pound sterling.

31.6. We refer HMT to our members' bilateral responses.

32. Equalities impact

Question 54 – Do you agree with the provisional assessment that the government's proposed reforms will not have an impact on those sharing particular protected characteristics?

Question 55 – If you disagree, do you have any further data you can provide on the potential impacts on persons sharing any of the protected characteristics?

32.1. We have no comments in response to these questions.

33. Conclusion

This response provides the collective views of our members, representing a broad cross-section of the industry, in so far as affected by the ring-fencing regime. RFB groups and others have provided or will provide separate bilateral responses with case studies and examples. We would be happy to explore any of the themes and more detailed responses set out here with HMT.

Responsible executive

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